THE PERILS OF IDOLS WORSHIP: THE KRAFT HEINZ LESSONS

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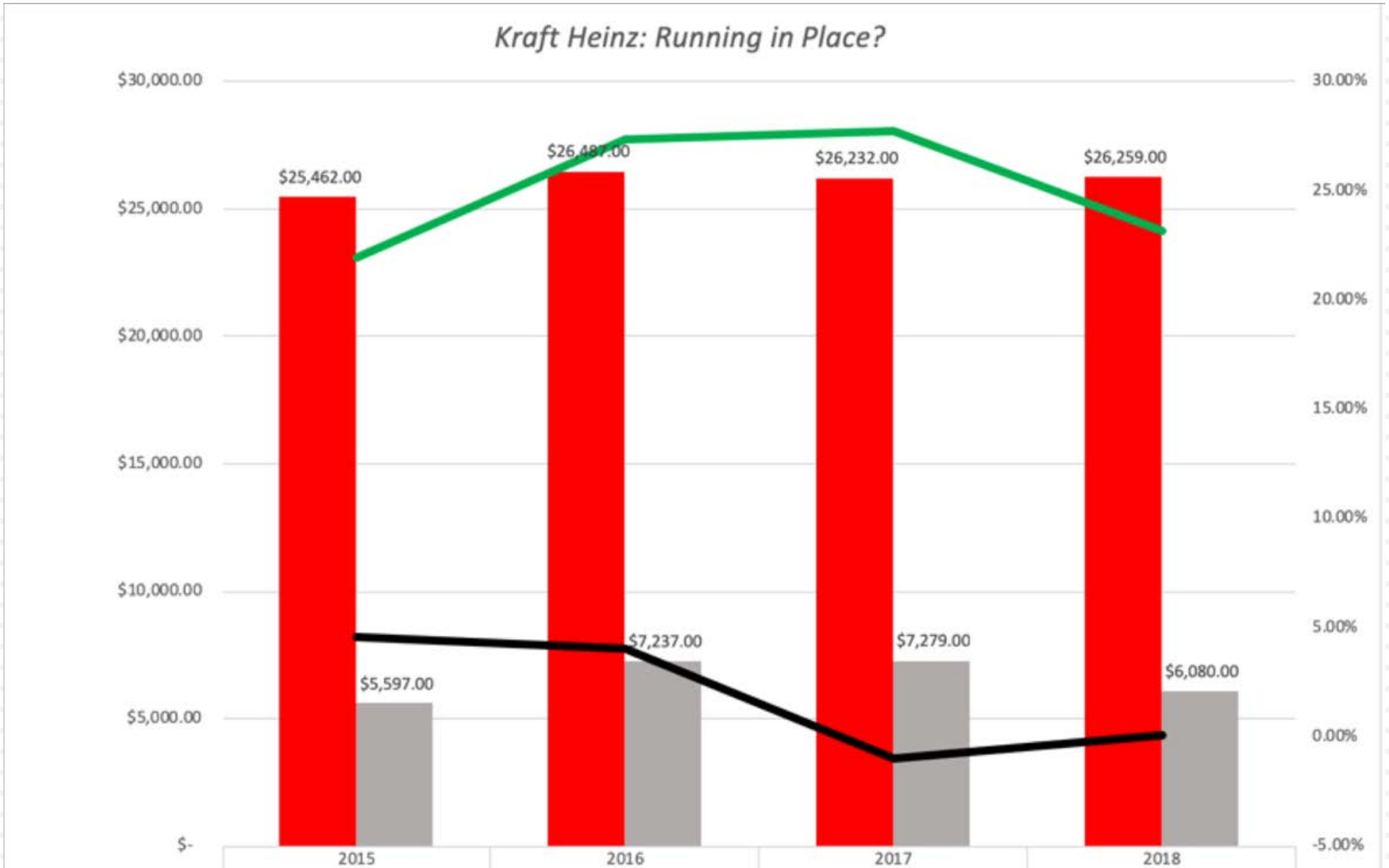
The Kraft Heinz Earnings Blow Up

- On February 22, Kraft-Heinz shocked investors with a trifecta of bad news in its earnings report: sub-par operating results, a mention of accounting irregularities and a massive impairment of goodwill, and followed up by cutting dividends per share almost 40%. Investors in the company reacted by selling their shares, causing the stock price to drop more than 25% overnight.
  - While Kraft is neither the first, nor will it be the last company, to have a bad quarter, its travails are noteworthy for a simple reason. Significant portions of the stock were held by Berkshire Hathaway (26.7%) and 3G Capital (29%), a Brazil-based private equity group.
  - Berkshire Hathaway's lead oracle is Warren Buffett, venerated by some who track his every utterance, and try to imitate his actions. 3G Capital might not have Buffett's name recognition, but its lead players are viewed as ruthlessly efficient managers, capable of delivering large cost cuts.
- In fact, their initial joint deal to bring together Heinz and Kraft, two of the biggest names in the food business, was viewed as a master stroke, and given the pedigree of the two investors, guaranteed to succeed. As the promised benefits have failed to materialize, the investors who followed them into the deal seem to view their failure as a betrayal.

The Back Story

- Heinz, the older of the two companies, traces its history back to 1869, when Henry Heinz started packing and selling horseradish, and after a brief bout of bankruptcy, turned to making 57 varieties of ketchup. Heinz was acquired by Berkshire Hathaway and 3G Capital for $23 billion, becoming a private company.
- Kraft started life as a cheese company in 1903, and over the next century, it expanded first into other dairy products, and then widened its repertoire to includes other processed foods. In 1981, it merged with Dart Industries, maker of Duracell batteries and Tupperware, before it was acquired by Philip Morris in 1988. After a series of convulsions, where parts of it were sold and rest merged with Nabisco, Kraft was spun off by Philip Morris (renamed Altria).
- In 2015, the two companies were brought together, with Berkshire Hathaway and 3G playing both match makers and deal funders, as Kraft Heinz, and the merger was completed in July 2015.

The Post-Merger Numbers



	2015	2016	2017	2018
Revenues	$25,462.00	$26,487.00	$26,232.00	$26,259.00
Operating Income	$5,597.00	$7,237.00	$7,279.00	$6,080.00
Operating Margin	21.98%	27.32%	27.75%	23.15%
Revenue Growth	4.55%	4.03%	-0.96%	0.10%

The Earnings Shock

- Flatlining Operartions: Revenues for 2018 were unchanged from revenues in 2017, but operating income dipped (before impairment charges) from $6.2 billion in 2017 to $5.8 billion in 2018; the operating margin dropped from 23.5% in 2017 to 22% in 2018.
- Accounting Irregularities: In a surprise, the company also announced that it was under SEC investigation for accounting irregularities in its procurement area, and took a charge of $25 million to reflect expected adjustments to its costs.
- Goodwill Impairment: The company took a charge of $15.4 billion for impairment of goodwill, primarily on their US Refrigerated and Canadian Retail, an admission that they paid too much for acquisitions in prior years.
- Dividend Cuts: The company, a perennial big-dividend payer, cut its dividend per share from $2.50 to $1.60, to prepare itself for what it said would be a difficult 2019.

Why the surprise?

- While investors were shocked, the crumb trail leading up to this report contained key clues. Revenues had already flattened out in 2017, relative to 2016, and the decline in margins reflected difficulties that 3G faced in trying to cut costs, after the deal was made.
- The only people who care about impairment charges, a pointless and delayed admission of overpayment on acquisitions, are those who use book value of equity as a proxy for overall value.
- The dividend cuts were perhaps a surprise, but more in what they say about how panicked management must be about future operations, since a company this attached to dividends cuts them only as a last resort.

Kraft Heinz

The Story

Kraft Heinz is an aging consumer product company, whose brands, while profitable, are no longer capable of delivering much growth. With competition increasing, especially in the rest of the world, operating margins will come under pressure, and while they will decline, they will not buckle. Finally, the company's use of debt has pushed down the cost of capital, but as operating numbers stagnate, the benefits of debt will fade, and Kraft Heinz will end up with a cost of capital more typical of a global food processing company.

The Assumptions

	Base year	*Years 1-5*	*Years 6-10*		*After year 10*	*Link to story*
Revenues (a)	$ 26,259	1.00% →	1.00%		1.00%	Changing market tastes limit growth
Operating margin (b)	22.07%	22.07% →	20.00%		20.00%	Margins continue to decline, as brand name power fades.
Tax rate	25.00%	25.00% →	25.00%		25.00%	Restructuring charges will keep near term taxes low
Reinvestment (c)		Sales to capital ratio	1.59	RIR =	16.66%	Maintain existing asset base
Return on capital	5.28%	Marginal ROIC =	0.34%		6.00%	Running in place, earning little or no excess returns
Cost of capital (d)		6.00% →	6.00%		6.00%	Company is in steady state and cost of capital is close to industry average.

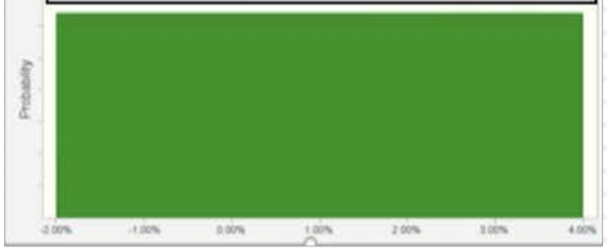
The Cash Flows

	Revenues	*Operating Margin*	*EBIT*	*EBIT (1-t)*	*Reinvestment*	*FCFF*
1	$ 26,522	21.66%	$ 5,744	$ 5,744	$ 165	$ 5,579
2	$ 26,787	21.24%	$ 5,690	$ 5,332	$ 166	$ 5,165
3	$ 27,055	20.83%	$ 5,635	$ 4,226	$ 168	$ 4,058
4	$ 27,325	20.41%	$ 5,578	$ 4,184	$ 170	$ 4,014
5	$ 27,598	20.00%	$ 5,520	$ 4,140	$ 171	$ 3,968
6	$ 27,874	20.00%	$ 5,575	$ 4,181	$ 173	$ 4,008
7	$ 28,153	20.00%	$ 5,631	$ 4,223	$ 175	$ 4,048
8	$ 28,435	20.00%	$ 5,687	$ 4,265	$ 177	$ 4,089
9	$ 28,719	20.00%	$ 5,744	$ 4,308	$ 178	$ 4,129
10	$ 29,006	20.00%	$ 5,801	$ 4,351	$ 180	$ 4,171
Terminal year	$ 29,296	20.00%	$ 5,859	$ 4,394	$ 732	$ 3,662

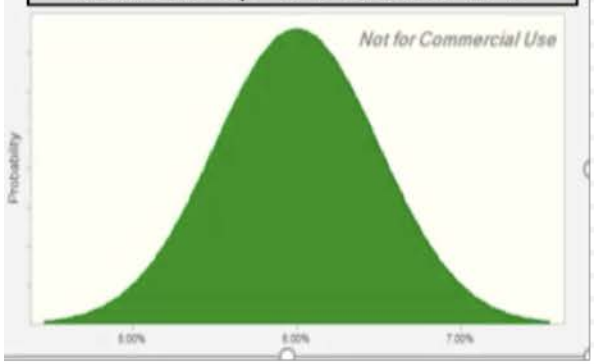
The Value

Terminal value	$ 73,212		
PV(Terminal value)	$ 40,872		
PV (CF over next 10 years)	$ 32,265		
Value of operating assets =	$ 73,137		
Adjustment for distress	$ -	Probability of failure =	0.00%
- Debt & Mnority Interests	$ 31,744		
+ Cash & Other Non-operating assets	$ 1,130		
Value of equity	$ 42,523		
- Value of equity options	$ -		
Number of shares	1,219.00		
Value per share	$ 34.88	Stock was trading at =	$34.23

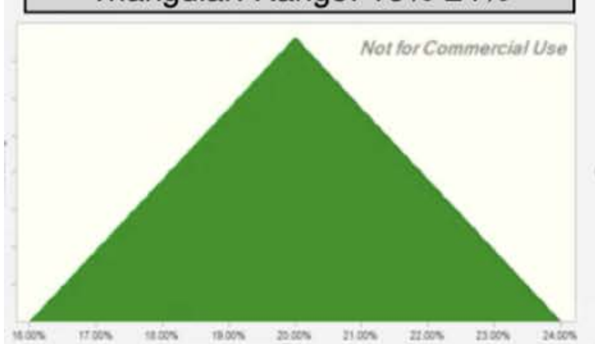
Revenue Growth Rate
Uniform: -2% - +4%



Cost of Capital
Normal: Exp =6% Std dev=.5%

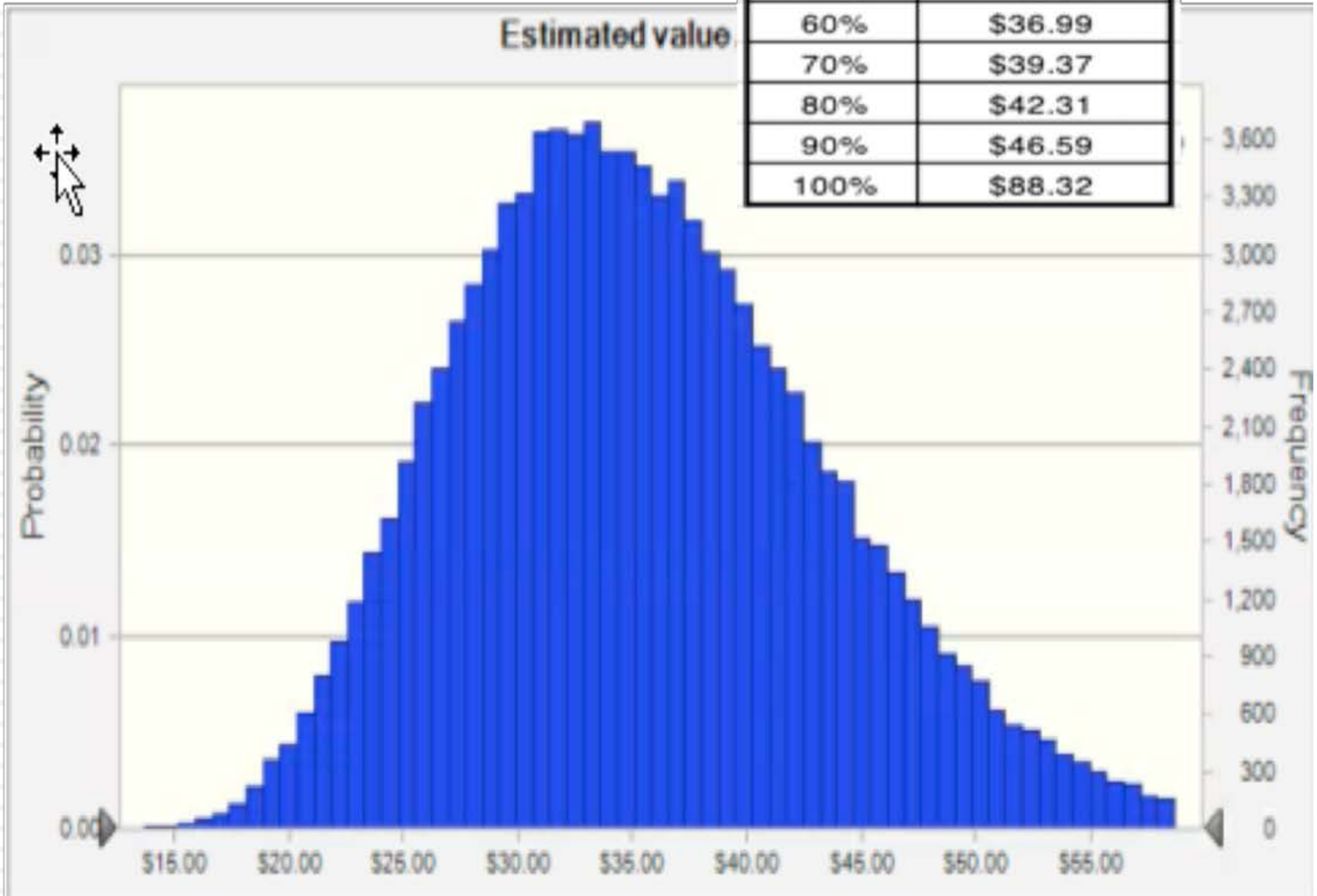


Target Operating Margin
Triangular: Range:-16%-24%



Kraft Heinz - Value per share
Simulation in February 2019

Percentile	Forecast values
0%	$13.72
10%	$25.56
20%	$28.46
30%	$30.76
40%	$32.77
50%	$34.82
60%	$36.99
70%	$39.37
80%	$42.31
90%	$46.59
100%	$88.32



The Action Follow up

- If you owned Kraft Heinz prior to the earnings report (and I thankfully did not), selling now will accomplish little. The damage has been done already, and the stock as priced now, is a fair value investment. I know that 3G sold almost one quarter of its hold 3 days after Tuesday, but that may say more about 3G than it does about Kraft Heinz.
- If you don’t own Kraft Heinz, the valuation suggests that the stock is fairly valued, at today’s price, but at a lower price, it would be a good investment. I have a limit buy on the stock at a $30 price, and if it does hit that price, I will be a Kraft Heinz stockholder, notwithstanding the fact that I think its future looks grim. If it does not drop that low, there are other fish to catch and I will move on.

Lesson 1: It is human to err

- At the risk of stating the obvious, Warren Buffett and 3G's key operators are human, and are prone to not only making mistakes, like the rest of us, but also to have blind spots in investing that hurt them.
- In fact, Buffett has been open about his mistakes, and how much they have cost him and Berkshire Hathaway shareholders. He has also been candid about his blind spots, which include an unwillingness to invest in businesses that he does not understand, a sphere that only grows as he gets older and the economy changes, and an excessive trust in the managers of the companies that he invests in.
- The fault, in my view, is not with Buffett, but with the legions of investors, analysts and journalists who treat him as an investment deity, quoting his words as gospel and tarring and feathering anyone who dares to question them.

Lesson 2: Stocks are not bonds…

- One reason that stocks like Kraft Heinz become attractive conservative value investors is because they offer high dividend yields, often much higher than what you could earn investing in treasury or even safe corporate bonds. In effect, the rationale that investors use is that by buying these shares, they are in effect getting a bond (with the dividends replacing coupons), with price appreciation.
- The underlying premise is that investors can count more on dividends than on buybacks. While it is true that dividends are stickier than buybacks, these dividend-based strategies become delusional when they treat dividends as obligated payments, rather than expected ones.
- Much as companies do not like to cut dividends, they are not contractually obligated to pay dividends. In fact, when a stock carries a dividend yield that looks too good to be true, it is usually almost always an unsustainable dividends.

Lesson 3: Brand Names last a long time, but not forever..

- A major lodestone of conventional value investing is that while technology, cost efficiencies and new products are all competitive advantages that can generate value, it is brand name that is the moat that has the most staying power.
- Again, that statement reflects a truth, which is that brand names last long, often stretching over decades, but even brand name benefits fade, as customers change and companies seek to become global.
- The troubles at Kraft-Heinz are part of a much bigger story, where some of the most recognized and valued brand names of the twentieth century, from Coca Cola to McDonalds, are finding that their magic fading.

Lesson 4: Cost cutting can take you far, but no further..

- For the last few decades, we have cut a great deal of slack for those who use cost cutting as their pathway for creating value, with many leveraged buyouts and restructurings built almost entirely on its promise.
- In firms with significant cost inefficiencies and bloat, cost cutting can deliver significant gains in profits, but even with these firms, those gains will be time limited, since there is only so much fat to cut out.
- Worse, there are firms that find themselves in trouble for a myriad of reasons that have little to do with cost inefficiencies and cutting costs as these firms is a recipe for disaster.

The Final Lesson

- I admire Buffett's adherence to a core philosophy and his willingness to be open about his mistakes, but I think he is ill served by his devotees, who insist on putting him on a pedestal and refuse to accept the reality that his philosophy has its limits, that like the rest of us, he has an ego and makes mistakes.
  - If you have faith in value investing, you should be willing to have that faith tested by the mistakes that you and the people you admire make in its pursuit.
  - If your investment views are dogma, and you believe that your path is only the correct one to success, I wish you the best, but righteousness and rigidity have never delivered positive investing payoffs.